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SUBJECT: Malaysian Islamic Finance Sector Performs Well During the Sub-Prime Crisis

REF A: 07 Kuala Lumpur 1462
REF B: 07 Kuala Lumpur 1429

¶1. (SBU) Summary: Malaysia continues to trumpet the virtues of Islamic finance and its role as a key player in the issuance of Islamic bonds. With no exposure to collateralized debt instruments, the Islamic financial sector has held steady during the sub-prime crisis. Secondary effects of the global financial downturn remain muted largely because of a widespread perception that Islamic financial products, which are required to be based on tangible underlying assets, are safe. As issuers struggle to meet the demand for Islamic investment products, Malaysia strives to be a global hub for this niche industry. Challenges include a dearth of talent and a lack of consensus by Shariah scholars on what is permissible under Islamic law. The success of sukuk (Islamic bonds) illustrates much potential for success when Shariah scholars agree. While Malaysia offers an array of incentives to develop the country's Islamic financial sector, the GOM's poor track record on the conventional side of the financial industry could make it a hard sell in the global marketplace. End Summary.

ISLAMIC BONDS (SUKUK) SEEN AS A SURE BET

¶2. (U) At a recent conference on Islamic Finance Dr. Zeti, Governor of Malaysia's central bank, told participants that issuances of global sukuk increased by 70 percent in 2007 and "held their ground" in the first half of 2008. The outstanding global sukuk market now surpasses USD 100 billion, she said, with more than 60 percent of those originating in Malaysia. While sukuk remain only a small fraction of the global bond market, they represent more than half the outstanding bond market in Malaysia. According to Moody's Investor Services, sukuk represent the fastest-growing segment of the Islamic finance market.

¶3. (U) Sukuk pay a fixed rate of return on certificates of ownership backed by income-generating tangible assets. Often, the rate is benchmarked to interest rates (usually LIBOR) in an effort to remain competitive with conventional financial products. While some Islamic scholars point out that this is simply interest by another name, many Muslim investors still prefer sukuk to conventional bonds, all other factors being equal. Most practitioners are willing to tolerate some level of "impurity" in Islamic financial practices in an effort to build the industry, with the hopes that someday Islamic finance will command a large enough segment of the market to be able to have its own benchmarks (ref A).

¶4. (U) Compared to the lack of consensus among Islamic scholars

regarding practices undergirding many other Islamic financial products, sukuk enjoy widespread acceptance both in the Middle East and in Southeast Asia. This near-consensus is largely responsible for their success, particularly with large amounts of petrodollars and sovereign wealth funds looking for safe, profit-bearing (and preferably Shariah-compliant) investments. One Saudi banker told Econoff that an added driver was that many Middle Eastern investors wanted to diversify their holdings, particularly in a post-9/11, post-Dubai Ports World environment of distrust.

ASSET-BACKED INVESTMENTS ARE PERCEIVED AS SAFER...

¶5. (U) Since Islam forbids the payment or collection of interest, financial transactions must be based on tangible assets. This solid basis provides investors with a sense of security. In addition, Islamic investment vehicles such as mutual funds exclude debt-ridden companies as well as those which rely heavily upon collecting debts from others. Islamic jurists tolerate some level of interest, invoking the Islamic "rule of necessity" in recognition that they could not realistically exclude every company that had an interest-bearing account or loan. The standards developed in the 1990s by the Dow Jones Islamic Indices have been adopted by practitioners across the globe: companies are excluded if their receivables are more than 45 percent of their assets, or if their debt is more than 33 percent of their market capitalization (based on a moving average). In some cases, companies with significant interest income (more than five or ten percent of their total income) also are excluded.

...BUT TRACKING WHO COMPLIES IS A CHALLENGE

¶6. (U) While in principle these cutoffs can result in a portfolio of

safer investments, implementation can be a problem: there is no effective mechanism to track the relative debts and assets of each company. Debt to asset ratios can change from week to week. As the sector grows, so does the challenge of keeping track of which companies comply with these standards.

A BIGGER CHALLENGE: TALENT

¶7. (U) By far a bigger barrier to the development of the Islamic finance industry is finding enough financial sector professionals versed in Islamic law, or enough Islamic scholars with a background in finance. Language is another challenge: the language of Islam is Arabic, while the language of finance is generally English. In the Middle East there is no limit to the number of Shariah boards a scholar can sit on, so a single scholar might officially sit on fifty boards but contribute little to each one. In Malaysia Shariah scholars are limited to a single board, and there simply are not enough scholars to go around. The differences in Islamic practices between Southeast Asia and the Middle East add yet another layer of complexity to training experts. In spite of the differences, though, Middle Eastern countries routinely recruit Islamic finance practitioners from Malaysia. Last year the GOM exempted Islamic finance experts from paying income taxes in an effort to make local jobs more competitive with the higher salaries being offered in some oil-rich countries without income tax regimes.

GOVERNMENTS GETTING IN ON THE ACTION

¶8. (U) In an analysis for the RGE Monitor, Rachel Ziemba noted that Gulf Cooperation Council (GCC) sovereign funds and government investment vehicles were scaling up their investments in Islamic finance. She speculates that this increased interest comes not only from the surge of petrodollars and the outperformance of many Islamic financial products during the credit crisis. It also is intended to promote domestic financial centers in an effort to keep money at home. Moody's suggests that government involvement lends credibility to skeptics concerned about whether such practices are truly compliant with Islamic law. Wider acceptance of Islamic banking practices could also result in expanding financial services

to citizens, an important concern for countries where large segments of the population remain unbanked.

¶9. (SBU) Rather than continue to hope Shariah scholars someday adopt an agreed set of underlying principles, one analyst pointed out that if Islamic finance reached critical mass in Malaysia, its national set of principles could become the global standard by default. As the sector grows, Hong Kong and Singapore are ramping up their interest in Islamic finance. The benefit to Malaysia is that these markets tend to lean toward the more lenient Malaysian model, offering some legitimacy to its standards. The risk is that these better-established financial centers could quickly surpass Malaysia as a global hub, particularly in light of Malaysia's reputation for heavy-handed, rather than even-handed, regulation of its conventional financial sector. One international banker told Econoff that Islamic finance was increasingly popular in Malaysia's domestic market; however, whether its bid to become a global financial center will be taken seriously in the global marketplace remains an open question.

COMMENT:

¶10. (U) The fledgling Islamic financial sector has received increased attention of late, largely due to its resilience during the ongoing sub-prime crisis. Despite gentle cajoling by the GOM, Islamic scholars are no closer to reaching consensus on what is permissible and what is not. Nevertheless, the niche market continues to grow in spite of the obstacles, and critical mass might determine which set of principles will be adopted in the global marketplace. In spite of Malaysia's best efforts to stay ahead of the pack, it could easily be surpassed by better-established financial sectors.

KEITH